SUPPORT FOR RESTRUCTURING THE BANKING SYSTEM

(ME-0227)

EXECUTIVE SUMMARY

Borrower and guarantor:	Nacional Financiera SNC, with the guarantee of the United Mexican States	
Executing agency:	Ministry of Finance and Public Credit (SHCP), the Bank Savings Protection Institute (IPAB) and the National Banking and Securities Commission (CNBV)	
Amount and source:	IDB (OC):	US$250 million
	Local:	US$0
	Total:	US$250 million
Financial terms and conditions:	Amortization period:	15 years
	Grace period:	5 years
	Disbursement period:	1.5 years
	Interest rate:	variable
	Inspection and supervision:	1 %
	Credit fee:	0.75%
	Currency:	U.S. dollar under the Single Currency Facility

Objectives: The objective of the program is to support measures to establish the conditions for recovery and continued development in the banking sector. The specific objectives are: (i) to strengthen the legal and regulatory framework of the banking system; (ii) to transfer shareholding ownership of banks under the financial program restructuring to the private sector, in a transparent and expeditious manner; (iii) to support efforts to maximize the recovery of bank loans and assets resulting from restructuring and portfolio purchases carried out during the crisis; and (iv) to implement a viable system for financing and absorbing costs arising from the financial crisis.

Description: The program calls for a comprehensive set of actions fundamental to the government's medium-term sector policy. These actions cover policy priorities for the sector over the coming 12 to 18 months, under five areas of reform: (i) the macroeconomic policy framework; (ii) the legal and regulatory framework for the banking sector; (iii) the resolution of banks under the financial restructuring program; (iv) liquidation of the banking portfolio and assets under the IPAB program transfer; and (v) adequate financing of costs arising from the crisis.

The Bank's country and sector strategy: The Bank's strategy for the financial sector has to date focused on supporting government efforts to reform and modernize the existing system of public development banks in Mexico. The Bank has financed programs for the modernization of NAFIN and Banobras (two of the most important development banks) and is preparing a second support operation for NAFIN's credit program (multisector credit program for US$300 million).

In recent months, the Mexican financial authorities have introduced fundamental reforms to the legal and institutional framework of the banking system. Those reforms include revisions to the protection that the State accords depositors and other creditors of the banking system (Bank Savings Protection Act), Commercial Reorganization and Bankruptcy Act, changes in the legal framework to strengthen the law governing guarantees, and new rules for bank capitalization.

These policy changes are intended to create a favorable legal and institutional framework for resolving the underlying problems of the banking system and they are opening new prospects for the Bank's participation in the sector. Participation in this process by the IDB, together with the World Bank and the IMF, is consistent with the Bank's strategic objectives for the country.

Environmental and social review: This program will have no environmental impact, since the activities called for are limited to institutional and legal reforms related to the financial sector. For these same reasons, the program will have no direct social impact.

Benefits: The reform program to be supported by proposed operation, which the government is pursuing in order to resolve fallout in the banking sector from the 1994-1995 financial crisis, is designed to strengthen the regulatory and institutional framework of the banking system. Over the medium term, these measures are intended to establish a soundly functioning banking system, improving solvency and efficiency among banking institutions as an essential element for the country's continued economic development. In addition, mechanisms will be set up to ensure gradual, orderly absorption of the costs stemming from the banking crisis.

Gradual withdrawal of the government guarantee for the obligations of commercial banks will generate a better incentive structure for the banking sector by transferring the risks associated with decisions by financial market participants to those making them. This will promote greater investor accountability and more discipline in the management of credit institutions. The gradual nature of this reform will help users adjust to the change and will consolidate an institutional and regulatory framework that will lead to certainty for all financial market participants.

Enactment and implementation of the law governing guarantees and the bankruptcy law have led to greater certainty about bankruptcy proceedings, creditors and debtors' rights are now safeguarded, abuses can be avoided, and legal proceedings are less protracted.

Risks:

Financial risks: one of the major challenges facing the IPAB is to manage its debt properly. The immediate objective of the authorities is to limit the growth of IPAB's debt to the inflationary component of interest, while paying the real component in cash. This will require steady and strict financial management by IPAB.

Political risks: the feasibility of the government program for the banking sector depends to a large extent on continued political support. Although there is no guarantee that such support will continue, particularly in light of the upcoming elections, the government program reflects an agreement with the political parties that have the largest representation in Congress.

Operating risks: it is very important for IPAB's credibility and the reactivation of the banking system that the bank resolution process, be conducted in a timely, transparent and financially viable manner, particularly in its initial phase. The recent interest shown by first-class banks in the institutions now being offered for sale suggests that the government's strategy has been successful in attracting new capital into the system.

Special contractual clauses:

Disbursements will be made in two tranches of US$150 million and US$100 million, respectively, subject to fulfillment of the conditions precedent indicated in Section III B and C and summarized in Annex I (Policy Matrix). The disbursement procedures will be those for sector adjustment loans established in document GN-2001-2, approved by the Board of Executive Directors (see paragraphs 4.3 and 4.4).

Poverty-targeting and social sector classification:

This operation does not qualify as a social equity enhancing project, as described in the key areas of Bank activity described in the Report on the Eighth General Increase in Resources (document AB-1704).

Furthermore, this operation does not qualify as a poverty-targeted investment (PTI) (see paragraph 4.7). The borrowing country will not be using the 10 percentage points in additional financing (see chapter IV).

Exceptions to Bank policy:	None
Procurement:	Not applicable, as explained in paragraphs 4.3 and 4.4.